

General Information Letter: Investment partnership with no property or employees in Illinois and whose only contact is through independent contractors has no "cost of performance" in Illinois for sales factor purposes.

April 5, 1999

Dear:

This is in response to your letter dated January 5, 1999, in which you request a letter ruling. The nature of your letter and the information you have provided require that we respond with a General Information Letter, which is designed to provide general information, is not a statement of Department policy and is not binding on the Department. See 86 Ill. Adm. Code 1200.120(b) and (c), enclosed.

In your letter you have stated the following:

Please provide written confirmation, at your earliest convenience, that (i) the investment partnership described below (referred to as "Limited Partnership") will not have net income allocable or apportionable to Illinois and therefore will not be required to file returns reporting any liability for Illinois personal property tax replacement income tax (hereinafter "replacement tax") and (ii) the partners of the Limited Partnership who otherwise are not subject to Illinois tax (that is, those who are nonresidents of Illinois or those who are persons other than residents that do not derive income from Illinois and are not engaged in a unitary business with the Limited Partnership) will not be subject to Illinois income tax or Illinois replacement tax on their shares of Limited Partnership income.

I. FACTS

Our client ("XY Co.") is a securities firm headquartered in New York, and is affiliated with entities that operate in a number of states, including Illinois. XY Co. and its affiliated entities provide investment and brokerage services to their clients who are located in the United States and elsewhere. XY Co. and its affiliated entities file income and other tax returns as required by the states where they conduct business activities.

Limited Partnership is a Delaware limited partnership that will invest, hold and trade in corporate securities and other equity positions for a limited number of investors. The Limited Partnership will have fewer than 100 partners and, as a result, will not be required to register as an investment company with the Securities and Exchange Commission. The Limited Partnership will not maintain any office, employee or property located in Illinois. The Limited Partnership's managing general partner (the "General Partner") will be a Delaware limited liability company based in New York and the General Partner will not maintain any office, employee or property located in Illinois.

XY Co. will own an interest in the General Partner; XY Co. will also provide investment advice and investment-related services to the Limited Partnership. XY Co. has offices located throughout the U.S., including Illinois, and it is anticipated that one or more of XY Co.'s Illinois employees may be called on to provide such investment advice and services to the Limited Partnership.

The investors (i.e., limited partners of the Limited Partnership) will include individuals, businesses, pension funds and nonprofit organizations that reside or are domiciled throughout the United States, and possibly outside the United States. Each investor will have sufficient income or assets to qualify as an "accredited investor" within the meaning of Regulation D under the Securities Act of 1993.

II. LEGAL ANALYSIS

Partnerships earning or receiving income in or as a resident of Illinois are subject to Illinois replacement tax at a rate of 1.5% of the partnership's Illinois net income for the taxable year. 35 ILCS 5/201(c) and (d). The Illinois Department of Revenue (the "Department") has ruled that a partnership is required to file Illinois replacement tax returns (Forms IL-1065) only if the partnership has net income that is allocable or apportionable to Illinois. See, e.g., Ill. Priv. Ltr. Rul. 86-0723 (Sept. 15, 1986)

Under Illinois law, investment income is allocable or apportionable depending on whether it is classified as "business income" or "nonbusiness income." "Business income" is defined to mean "income arising from transactions and activity in the regular course of the taxpayer's trade or business, net of the deductions applicable thereto, and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." 35 ILCS 5/1501(a)(1). Under the so-called "functional test," income is business income if it arises out of assets used in the taxpayer's regular business operations. See, e.g., Texaco-Cities Service Pipeline Co. v. McGaw, No. 82988 (Ill. Apr. 16, 1998) (gain from disposition of oil and gas pipeline was business income because the pipeline was used in the taxpayer's regular trade or business operations); Kroger Co. v. Illinois Department of Revenue, 284 Ill. App. 3d 473 (1996), app. denied, 117 Ill. 2d. 567 (1997) (gains from sales of grocery store leases were treated as business income under the functional test). The Department's regulations provide that a taxpayer's income shall be treated as apportionable business income, unless it is clearly classifiable as nonbusiness income. 86 Ill. Admin. Code § 100.3010(a). For purposes of this ruling, we anticipate that the Limited Partnership's income arising from dividends, interest and capital gains from its investment assets and related investment activities will be treated as apportionable business income.

Under Illinois law, a "financial organization" apportions its business income through use of a single gross receipts factor; all other taxpayers are required to use a three-factor formula consisting of property, payroll and sales factors, unless another specific provision applies. 35 ILCS 5/304(a), (c), and (h), and 305 (c). The term "financial organization" is defined to mean any bank, bank holding company, trust company, savings bank, industrial bank, land bank, safe deposit company, private banker, savings and loan association, building and loan association, credit union, currency exchange, cooperative bank, small loan company, sales finance company, investment company, or any person which is owned by a bank or bank holding company. 35 ILCS 5/1501(a)(8)(A). The Department has issued proposed regulations that define the term "investment company" as an entity that is predominantly engaged in the business

of raising capital from investors in order to invest, reinvest and trade in capital securities of other entities. Proposed Reg. § 100.9710(d)(11). The proposed regulation further provides that in order to be characterized as an "investment company" under the Illinois Income Tax Act, an entity doing business in Illinois must register its shares under 815 ILCS 5/7, and an entity doing business in the United States must be registered as an investment company with the Securities and Exchange Commission. Prop. Reg. § 100.9710(d)(11)(B).

The Limited Partnership described herein will not be required to register, and will not be registered, with the SEC or with the Illinois Secretary of State. As a result, the Limited Partnership will not qualify as a "financial organization" under the proposed regulation and will be required to utilize the general three-factor formula under Illinois law to determine if it has apportionable business income subject to Illinois tax.

The Limited Partnership will have no property factor and no payroll factor because it will not own or rent any real or tangible personal property and it will not have any employees. See, 35 ILCS 5/304(a)(1) and (2); and 86 Ill. Admin. Code §§ 100.3100, 100.3350 and 100.3360(a) (payroll factor includes only compensation paid in Illinois to the taxpayer's employees). In determining the Illinois sales factor, gross receipts are included in the numerator of the sales factor only if the income-producing activity that gave rise to the gross receipts is performed wholly within Illinois or is performed both within and without Illinois and a greater proportion of the income-producing activity is performed in Illinois than outside the state, based on costs of performance. 35 ILCS 5/304(a)(3)(C); 86 Ill. Admin. Code § 100.3370(c)(3). The term "income-producing activity" includes transactions and activities directly engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of obtaining gain or profit.¹ An income-producing activity does not include transactions and activities performed on behalf of the taxpayer, such as those conducted on its behalf by an independent contractor. 86 Ill. Admin. Code § 100.3370(c)(3)(A).

The Limited Partnership discussed herein will not maintain an office or any employee in Illinois, and its managing General Partner will not maintain an office or any employee in Illinois. The Limited Partnership will receive investment advice and investment services from various sources; some of that advice and service may be obtained from employees working out of Illinois offices of XY Co., but none of the advice and service will be rendered by employees of the Limited Partnership or its managing General Partner. Since the Department does not attribute income-producing activities to an investment partnership based on services provided to that partnership by a person other than an employee, we respectfully submit that the Limited Partnership will not have any income allocable or apportionable to Illinois and will not be required to file Illinois tax returns reporting any liability for Illinois replacement tax purposes.

¹ In Illinois Private Letter Ruling IT-91-104 (April 16, 1991), an investment partnership had an income-producing activity in Illinois, which gave rise to an Illinois sales factor, where the partnership maintained an office and two employees in Chicago to trade securities on the floor of the Chicago Board of Options Exchange.

Individual partners who are residents of Illinois allocate and pay Illinois income tax on all of their Illinois net income, including their shares of net income of the partnership. 35 ILCS 5/301(a) and 1501(a)(20). Partners other than residents of Illinois report and pay Illinois income tax and/or replacement tax on their respective shares of so much of the business income of the partnership as is allocated or apportioned to Illinois in the possession of the partnership and on their respective shares of items of nonbusiness income of the partnership that would be allocated to Illinois if paid, incurred or accrued directly to the partners in their separate capacities. 35 ILCS 5/305(a) and (b). Any corporate partner that is unitary with the partnership must include its share of the partnership's income and apportionment factors on its Illinois tax return. 86 Ill. Admin. Code § 100.3380(c).² Thus, if the Department rules that the Limited Partnership does not have income allocable or apportionable to Illinois, and therefore is not subject to Illinois replacement tax, then partners who are nonresidents of Illinois and partners other than residents that do not derive income from Illinois and that do not conduct a unitary business with the Limited Partnership will not be subject to Illinois tax on their shares of Limited Partnership income.

Response

Section 304(a) of the Illinois Income Tax Act (the "IITA"; 35 ILCS 5/101 et seq.) provides:

The business income of a person other than a resident shall be allocated to this State if such person's business income is derived solely from this State. If a person other than a resident derives business income from this State and one or more other states, then, for tax years ending on or before December 30, 1998, and except as otherwise provided by this Section, such person's business income shall be apportioned to this State by multiplying the income by a fraction, the numerator of which is the sum of the property factor (if any), the payroll factor (if any) and 200% of the sales factor (if any), and the denominator of which is 4 reduced by the number of factors other than the sales factor which have a denominator of zero and by an additional 2 if the sales factor has a denominator of zero. For tax years ending on or after December 31, 1998, and except as otherwise provided by this Section, persons other than residents who derive business income from this State and one or more other states shall compute their apportionment factor by weighting their property, payroll, and sales factors as provided in subsection (h) of this Section.

The Illinois numerator of the property factor is defined in Section 304(a)(1) of the IITA as "the average value of the person's real and tangible personal property owned or rented and used in the trade or business this State during the taxable year." Thus, a taxpayer that neither owns nor rents real property or tangible personal property in Illinois will have no property factor.

² Otherwise the corporate partnership subtracts nonunitary partnership business income from the corporate partner's base income subject to apportionment and then adds such nonunitary partnership income to the corporate partner's Illinois business income (i.e., after the apportionment formula has been applied) only to the extent that the income was apportionable to Illinois in the hands of the partnership. Form IL-1120, Part III, Lines 2b and 10.

Under Section 304(a)(2) of the IITA, the payroll factor is based on "compensation." "Compensation" is defined in Section 1501(a)(3) of the IITA to mean "wages, salaries, commissions and any other form of remuneration paid to employees for personal services." Thus, payments to persons who are not employees cannot be included in the payroll factor. Section 304(a)(2)(B) of the IITA provides that compensation is included in the Illinois numerator of the payroll factor if:

(i) The individual's service is performed entirely within this State;

(ii) The individual's service is performed both within and without this State, but the service performed without this State is incidental to the individual's service performed within this State; or

(iii) Some of the service is performed within this State and either the base of operations, or if there is no base of operations, the place from which the service is directed or controlled is within this State, or the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the individual's residence is in this State.

All of these tests for determining when compensation is included in the numerator require that the employee perform at least some services in Illinois. Thus, a taxpayer with no employees present in Illinois at any time will have no Illinois payroll factor.

Section 304(a)(3)(C) of the IITA provides that sales (other than sales of tangible personal property) are included in the Illinois numerator of the sales factor if:

(i) The income-producing activity is performed in this State; or

(ii) The income-producing activity is performed both within and without this State and a greater proportion of the income-producing activity is performed within this State than without this State, based on performance costs.

86 Ill. Admin. Code § 100.3370(c)(3)(A) explains that:

The term "income producing activity" applies to each separate item of income and means the transactions and activity directly engaged in by the person in the regular course of its trade or business for the ultimate purpose of obtaining gains or profit. Such activity does not include transactions and activities performed on behalf of a person, such as those conducted on its behalf by an independent contractor. The mere holding of intangible personal property is not, of itself, an income producing activity.

86 Ill. Admin. Code § 100.3370(c)(3)(B) further explains that:

The term "costs of performance" means direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the person.

Under these provisions, a taxpayer with no property or employees in Illinois at any time would not be conducting any income-producing activity within Illinois and no costs of performance associated with any income-producing activity of that taxpayer would be incurred in Illinois.

As stated above, this is a general information letter which does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department. If you are not under audit and you wish to obtain a binding Private Letter Ruling regarding your factual situation, please submit all of the information set out in items 1 through 8 of the enclosed copy of Section 1200.110(b).

Sincerely,

Paul S. Caselton
Associate Chief Counsel -- Income Tax